



PORTFOLIO CONSTRUCTION

Words From the Wise: Harry Markowitz on Portfolio Theory and Practice

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Harry M. Markowitz, the father of Modern Portfolio Theory, responded to a series of questions from Antti Ilmanen and Rodney N. Sullivan of AQR including about how MPT remains an important tool for use in contemporary challenges facing investors. This is the fourth in a series of “Words From the Wise” interviews to be published on AQR.com.

Some 65 years ago, Harry Markowitz first envisioned and then formalized a solution to portfolio selection that became the cornerstone of Modern Portfolio Theory, referred to simply as MPT. We begin with a discussion about why his mean-variance analysis (MVA) remains so central to MPT — and, indeed, to finance — and why it has stood the test of time. We gain from Harry’s deep perspective and lessons learned to understand why the simple, but not simplistic, MVA is so useful to practitioners and how portfolio variance, a key input to MVA, stacks up to alternative risk measures. Harry also addresses the “Great Confusion,” a term he gives to the recent criticisms of MVA following the global financial crisis. He describes how these criticisms are not only unfounded, but that his theory of portfolio selection and diversification is as relevant to investors today as ever before. Consider that if investors are leverage averse the market portfolio may not be a mean-variance efficient portfolio and also the relationship between expected returns and beta may not be positive linear as posited by CAPM theory.

A perennial intellectual, Harry discusses how he has pursued academic interests since grade school, and the ideas and people that influenced him both intellectually and professionally. We learn how he came to study financial economics and the “eureka moment” that led to his envisioning the timeless solution to the portfolio-selection problem. Harry’s forward thinking doesn’t end with portfolio theory; we also learn about his early and meaningful contribution to the development of advanced simulation software.

Almost seven decades after his seminal paper on portfolio selection, Harry Markowitz is still going strong. We discuss his current focus and plans for future research, including a comprehensive four-volume book on risk-return analysis and the theory of rational investing, an effort currently well underway. Finally, we hear about Harry’s heroes, accomplishments and his biggest regret.

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